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SUBJECT: ARMENIA - MACROECONOMIC OVERVIEW FOR 2007

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SUMMARY

¶1. Armenia's economy continued its double-digit growth trend of the past five years, again driven primarily by the construction and service sectors. The gap between import and export of goods and services continued to increase, and year-end inflation was 6.6 percent. The Armenian Dram appreciated a further 16.6 percent against the US dollar in 2007. Foreign Direct Investment almost doubled year-on-year, most of the investment being made in the telecommunications sector. Following higher-than-expected revenues, the state budget achieved a small surplus of 0.1 percent of GDP. End Summary.

STRONG GROWTH DRIVEN BY CONSTRUCTION AND SERVICES

¶2. GDP growth remained high in 2007, at 13.7 percent, compared to the GOAM's projection of nine percent. GDP in 2007 was USD 9.2 billion at current prices, while GDP per capita was equal to USD 2,844.

¶3. As in recent years, the primary driver of economic growth has been construction, which accounted for approximately one-third (4.5 percentage points) of the overall GDP growth rate, followed by the services sector, with a four percentage point contribution. Agriculture and industry (energy sector included) made modest contributions to GDP growth, with 1.7 and 0.6 percentage points respectively.

¶4. The construction sector expanded by 18.4 percent in 2007, and accounted for 25.6 percent of GDP. However, this growth is considerably lower than the 38.9 percent growth registered in 2006. The bulk of construction growth occurred in the transport and communication sectors, as well as in road construction projects. Significant growth of capital construction was also recorded in the energy sector, particularly due to implementation of investment projects in small hydropower plants, and other energy sector facilities, including the construction of the second portion of the Iran-Armenia gas pipeline. Private funds constituted 62 percent of spending in the construction sector. The volume of housing construction decreased considerably in 2007, due to the completion of some major residential and commercial construction projects in downtown Yerevan.

¶5. The service sector posted a 12.4 percent year-on-year increase, accounting for 32.5 percent of GDP. High growth rates in transport and communication services persisted in 2007, with 20 percent and

23.8 percent growth respectively compared with 2006. Financial services posted 24.5 percent growth.

¶6. The industrial sector contributed 0.6 percentage points to 2007 GDP growth. Industrial output (energy sector included), which comprised 15.7 percent of overall GDP (compared to 17.9 percent in 2006) increased by 3.2 percent in 2007, against a 0.3% decline in 2006. Manufacturing output increased by 1.3 percent, with the two largest sub-sectors -- food processing and metallurgy -- growing 7 percent and 13.8 percent respectively. However, contractions in the textile, tobacco, and diamond sub-sectors dragged down the manufacturing sector's growth as a whole. The jewelry sector continued to decline in 2007, falling 47.3 percent from 2006.

¶7. The agricultural sector recovered in 2007, with output growth of 9.6 percent, compared with 0.4 percent growth in 2006. Agriculture contributed 1.7 percentage points to the overall growth of the economy, accounting for 17.5 percent of GDP. Considerable growth in agriculture was mainly due to the 12.3 percent growth in crop-growing output.

PRICES INCREASE

¶8. While the inflation rate averaged 4.4 percent for 2007, a 10.9 percent increase in food prices toward the end of the year raised the year-end rate to 6.6 percent. Also contributing to this rate was a 25.7 percent increase in household incomes due to large external remittances and an increase in average monthly wages. Inflation exceeded the original 5.5 percent annual target set by the Central Bank of Armenia (CBA) by 1.1 percentage points. To dampen inflationary pressures, the CBA raised the repo rate (the rate at which it repurchases government securities from commercial banks) several times during the year, reaching 5.75 percent in December. However, due to an underdeveloped domestic money market and a low

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level of banking intermediation, the impact of this rate change was limited.

DRAM CONTINUES TO APPRECIATE

¶9. The Armenian Dram (AMD) continued to appreciate in 2007 and was valued at 304.1 AMD to the dollar in December 2007, up by 16.6 percent compared to December 2006. While the exchange rate was relatively stable in the first half of 2007, the appreciation trend picked up sharply in the second half. The main causes of the Dram's appreciation were large inflows of foreign remittances and the global weakening of the U.S. dollar. According to the Central Bank of Armenia (CBA), individual cash inflows through commercial banks were equal to USD 1.32 billion in 2007, up by 37.3 percent compared to 2006. The amount of actual remittances is considerably higher, however, as significant amounts flow into the country through non-bank transfers.

EMPLOYMENT AND WAGES INCREASE

¶10. The official unemployment rate was 7.1 percent in 2007, down from 7.4 percent in 2006, due primarily to expansion of services and construction activities. However, the real unemployment rate, according to household surveys conducted by the National Statistical Survey in 2006, remains very high at around 27 percent. According to official figures, 30.2 percent of unemployed were between ages 35-45, and 24.8 percent between ages 46-57. Unemployment among women is much higher than among men. Average monthly nominal wages were equal to approximately USD 220 in January to November 2007, a 20.2 percent increase compared to the same period in 2006. The highest wages were registered in the financial services sector (USD 645), followed by the mining sector (USD 460) and the energy sector (USD 320).

HIGHER REVENUES RESULT IN SMALL BUDGET SURPLUS

¶11. According to preliminary data from the Ministry of Finance and Economy, total revenues and official transfers under the State Budget were equal to USD 1.67 billion, up by 29.7 percent compared to 2006 (as calculated in AMD). Expenses totaled USD 1.65 billion, an increase of 24.4 percent compared to 2006. The budget posted a small surplus of USD 12.3 million. Total tax revenues grew by 34.5 percent, due principally to a large increase in VAT proceeds (up 49.5 percent). Tax revenues accounted for 84.8 percent of total budget revenues, state duties 3.8 percent, and non-tax and capital revenues 10.2 percent. Tax/GDP ratio (without state duties) was equal to 15.4 percent, compared to 13.5 percent in 2006.

¶12. Expenditures on science and education increased by 23.8 percent, equal to 2.8 percent of GDP. Health expenditures were up by 25 percent, or 1.4 percent of GDP.

FOREIGN TRADE DEFICIT EXPANDS

¶13. During 2007 total trade turnover grew by 39.7 percent, reaching USD 4.44 billion, with exports equal to USD 1.16 billion and imports equal to USD 3.28 billion. Imports showed a robust 49.7 percent growth in 2007, largely owing to increased imports of food, minerals, chemicals, base metals, as well as machinery and equipment. Exports grew by 17.5 percent in 2007, compared to a modest 3.1 percent growth in 2006. Leading export product groups included food products, minerals, base metals and precious and semi-precious stones and metals, as well as products made from them. The trade deficit was equal to USD 2.12 billion. Armenia's main export partners were Russia (17.4 percent of total exports), Germany (14.7 percent), Netherlands (13.5 percent), Belgium (9.1 percent), Georgia (7.5 percent). The leading import partners were Russia (15.3 percent), Ukraine (7.7 percent), Kazakhstan (7.3 percent), Germany (6.8 percent) and China (5.9 percent). Armenia's trade with Russia increased by 65 percent, with the volume of bilateral trade reaching USD 704 million. Overall, the trade with CIS countries increased by 58.7 percent, totaling USD 1.44 billion. Trade with European Union countries increased 44.9 percent, totaling USD 1.7 billion. The U.S. share was equal to 4.4 percent of overall trade turnover.

FOREIGN DIRECT INVESTMENT DOUBLES

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¶14. Foreign investment increased by 58 percent in January-September 2007, compared to the same period in 2006, totaling USD 469.9 million. Foreign Direct Investment (FDI) more than doubled in this period to USD 311.6 million. The leading foreign investor was Russia (USD 175.9 million), followed by Lebanon (USD 134 million). As in the previous year, FDI inflows were primarily in telecommunications (40.9 percent of the total), followed by the energy (17.6 percent) and mining sectors (8.3 percent). Investment in the telecommunications sector came from Russia and Lebanon, through two telecom operators in Armenia, Vivacell and Armentel, which are now owned by Russian companies MTS and Vimpelcom, respectively. Investment in the energy sector also came primarily from Russia, through ArmRosgazprom, which has a monopoly on gas supply and distribution in the Armenian market. The main investor in the mining sector is Germany, through Cronimet company. FDI from the U.S. was still low at 15.9 million (a 10 percent decrease compared to the same period in 2006) and was mostly in hotel services, research and development, and other service sectors.

COMMENT

¶15. Although construction remains the main driver of economic growth, trade, communications and transport are also now making considerable contributions as well. With the expansion of the mining and metallurgy sectors, the industrial sector should also post higher growth in 2008. Despite these positive trends, however, the potential of continued appreciation of the Armenian Dram could create a serious threat to the competitiveness of Armenian products in international markets.

PENNINGTON